2Q22 Market Overview: Forever Changes

Financial markets continued to stagger in the second quarter. Though the pain was broad-based, the suffering was felt most acutely in the stock markets, which posted the worst first half of a year since 1970.[1] The S&P 500 Index and the MSCI World Index both slipped into bear markets during the period as they lost an additional 16.1% and 16.2%, respectively.[2] Meanwhile, many of the first quarter's equity market dynamics continued to be felt in the second, most notably the significant outperformance of value relative to growth.

With inflation showing few signs of abating from current multi-decade highs, Federal Reserve rhetoric and action appears focused on achieving price stability before elevated inflation levels become anchored in the national psyche. This effort comes with no small risk, as past attempts to engineer a "soft landing" have shown. With signs of strain already evident in the real economy and bond market signals—and a variety of other secular dynamics providing additional headwinds—it's clear central bankers have their work cut out for them.

In an environment of pronounced volatility and uncertainty, First Eagle's Global Value team has continued to look for opportunities to allocate capital to companies we believe possess scarce, durable assets that will support business resilience over the long term, and do so at what we consider attractive prices.

KEY TAKEAWAYS

- We believe the very poor performance seen across asset classes in the first half of 2022 is mostly attributable to the conditions that were extraordinarily supportive of asset prices, including a very low cost of capital and very low energy prices.
- While inflation remains elevated despite tightening financial conditions, signs of strain are evident in the real economy. The accompanying pullback in long Treasury yields and inversion of the yield curve suggests the bond market is pessimistic about a "soft landing" scenario.
- A return to the supportive conditions that fueled markets following 2020's Covid selloff may be further off than some think, in our view, especially if recession hits.
- The year-to-date selloff has created what the Global Value team views as attractive opportunities to put money to work in companies we believe will be resilient in the face of volatile markets.

Views expressed are as of July 20, 2022.

1. Source: Dow Jones Market Data; data as of June 30, 2022.
2. Source: FactSet; data as of June 30, 2022.

Past performance is no guarantee of future returns.

Extraordinary Policy Accommodation Is Fading Fast

We believe the fall from grace across asset classes thus far in 2022 largely has been the result of the normalization of what had been extraordinarily supportive conditions—including the shift away from generationally low costs of capital and energy.

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With central banks led by the US Federal Reserve seeking to tame multidecade-high inflation by dampening aggregate demand, interest rates have moved higher across the yield curve, raising the cost of capital for businesses and consumers that also are contending with energy prices about double what they were 12 months ago. At the same time, there has been an unwind of the massive fiscal stimulus that had helped fuel markets' rebound from the Covid swoon; the US budget deficit is forecast to fall to 4.8% of GDP in 2022 and 3.8% in 2023, down from 12.4% in 2021 and approaching the 50-year average of around 3.5%.[3]

Toward the end of the second quarter and into the beginning of the third, however, tighter financial conditions appeared to inspire fear not just of an inflation-dampening economic deceleration but of a full-fledged recession. Indeed, we have begun to see signs that fiscal tightening and higher interest rates are causing demand to soften; in the US, for example, consumer sentiment has deteriorated, manufacturing activity is slowing and mortgage applications are down.[4] The impact of recessionary concerns was most evident in the bond markets. After climbing near 3.5% by mid-June—from close to 1.5% to start 2022—the 10-year US Treasury finished the first half of the year near 3.0%, a rally that suggests to us that markets expect central bank policy restraint to come to a premature end in the face of withering economic growth.[5] Meanwhile, the yield curve inverted briefly twice during the second quarter and has entered into a lengthier negative position in early July; such inversions have long been regarded as a potential harbinger of recession.[6]

Get Back

We think that a return to the conditions that prevailed in the aftermath of the Covid-19 swoon—namely, moderate inflation and a very low cost of capital—may be further away than some may think. In fact, things may get worse before they get better, especially if we are on the cusp of recession, suggesting a more complicated investment environment looking forward.

Many of the components of core CPI—such as healthcare, education, entertainment and rent—are quite sticky and may not be as quick to soften as commodity-driven inputs, which could keep core inflation prints elevated even as non-core elements ease. A more accommodative Fed combined with a widening current account deficit could weigh on the dollar, pushing the cost of imports higher and adding to inflationary pressures. The Fed balance sheet remains a concern as well; despite flat money supply growth in 2022, we estimate there are about $5 trillion or so in excess reserves as a result of pandemic-related accommodations, and whatever surplus remains at the end of the current Fed tightening cycle may be fodder for future pricing pressures.

However, our most pressing inflationary concern may be the fiscal deficit. While the Congressional Budget Office forecast for the deficit, mentioned earlier, is relatively sanguine, it's not hard to envision multiple sources of negative drift that could push the deficit as a percentage of GDP back into the double digits. Debt-servicing costs appear biased higher as low-rate Treasury debt matures and is replaced by issuance with yields in the 2–3% range. An increase in unemployment off current low levels could slash tax revenues while increasing expenditures in the form of automatic stabilizers, while the country's aging demographics have a similar two-pronged effect on federal receipts and outlays. Meanwhile, the capital gains tax windfall paid on 2021 market gains seems unlikely to be repeated next year, taking another chunk out of the revenue basket.

3. Source: Congressional Budget Office; data as of June 30, 2022.
4. Source: Bureau of Labor Statistics, Institute for Supply Management, Mortgage Bankers Association; data as of June 30, 2022.
5. Source: Bloomberg; data as of June 30, 2022.
6. Source: Bloomberg; data as of July 15, 2022.

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Of course, other considerations are playing out beyond US shores. While it seems to have receded from the headlines somewhat, the war between Russia and Ukraine continues to impact market dynamics, as evinced by the steady decline of the euro versus the US dollar over the course of 2022. Already struggling under the weight of high prices, Europe will soon head into colder weather with the potential threat of a cutoff in Russian gas supply hanging over its head; on the flip side, this prospect may prompt European leaders to pressure Ukraine into reaching some sort of peace agreement with Russia. Meanwhile, elevated food and energy prices are fostering unrest worldwide, led by but not limited to developing markets.

China, meanwhile, has pivoted from contractionary policy to once again stoking its economic engine; not coincidentally, China was one of the few equity markets to deliver a positive return in the second quarter.[7] That said, it's unlikely that China will provide the type of stimulus it did in 2008–09, which catapulted the country out of its global financial crisis slump and bolstered the global economy. Further, the periodic lockdowns' associated with the country's zero-Covid policy may continue to cause disruptions to global supply chains.

> Things may get worse before they get better, especially if we are on the cusp of recession as some fear.

Sowing Seeds

While the market's year-to-date swoon has been painful, the selloff created opportunities for us to put money to work in companies we expect to perform well over the long term, allowing us to enlarge certain existing exposures and to add new ones. Ultimately, we feel good about the prospects for the securities we own and the prices we paid for them, and as a result we are comfortable enduring the uncertainty and volatility we expect in financial markets.

7. Source: MSCI; data as of June 30, 2022.

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